Mergers & Acquisitions and Corporate Finance

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Mika J. Lehtimäki, partner
+358 (0)40 534 2273
Attorneys-at-Law TRUST.
Mika.Lehtimaki@theTrust.fi
www.theTrust.fi
HELSINKI - HÄMEENLINNA

Jan Lindberg, partner
+358 (0)40 823 6031
Magnusson Helsinki
Attorneys-at-Law Ltd
jan.lindberg@magnussonlaw.com

Mika J. Lehtimäki *heads* ***Attorneys-at-Law TRUST****. He has 12 years' experience on Finnish and cross-border M&A and financial transactions in the Nordic area and Russia. Mika Lehtimäki has graduated from the University of Helsinki and he holds two post-graduate law degrees from the University of Oxford, where he has also acted as the co-governor of the financial law group. He is a member of the Finnish Bar Association, and Turnaround Management Association. Chambers Global 2011 and Chambers Europe 2011 have listed him as a leading lawyer in Banking & Finance in Finland and Corporate INTL as the Banking & Finance lawyer of 2011 in Finland. In addition to his native Finnish, he is fluent in English and is also able to advice in Swedish and Russian.*

Jan Lindberg *is a partner at* ***Magnusson Helsinki Attorneys-at-Law Ltd*** *and an expert in domestic and cross-border M&A and private equity, outsourcing and also heads the IP and technology practice. He has a post-graduate degree from the University of Oxford and exceptional track-record of international deals from US to Japan. Jan is listed as one of the leading Finnish lawyers in this field and recognized by several neutral lawyer surveys such as Chambers Global, Chambers Europe, Legal 500, IAM 250 World's Leading Patent and Technology Lawyers.*

VOLATILE MARKET AND AMPLE OPPORTUNITIES

The single biggest factor affecting the volume of M&A transactions in Finland at the end of 2011 is corporate financing - especially difficulties in securing financing for the deal. As the market participants are aware, there are major underlying causes to this and the volatility of the market.

The on-coming ”debt maturity wall” along with the European debt crisis, the US debt problems and the realignment of economic power towards the East has caused many market players to take a step back and wait for the clearing of the skies.

However, a ”grassroot” point of view from a specialist M&A/Finance practice is that there is plenty of deal appetite, willing buyers and sellers, and even the valuations appear to be getting closer to a level capable of leading to a deal. In other than cash deals, what is required is providing the financier with adequate security of the feasibility of the deal and the cash flows.

We examine in this update the current market situation of M&A and acquisition finance in Finland; talk about some ways to overcome the difficulties for getting the deal done; and give our views how the restructuring scenarios might be handled.

TRENDS IN ACQUISITION FINANCE

Acquisition Finance Dried Up

Despite the fact that the acquisition finance and restructuring departments of the Nordic Finnish banks have indicated that they are almost fully occupied, the deal flow of major acquisition finance transactions dried up after the Summer of 2011.

The trend appears to be that even relatively small local acquisition financing decisions are taken to the banks' higher level credit committees and M&A finance departments. On the other end of the spectrum, we expect to see some public to private takeovers carried out at least partially by debt financing. The valuation levels of some Finnish listed companies have suffered due to the general market turmoil and this is apt to trigger the interest of takeover funds planning on strategic consolidation in the European markets.

It appears that reputable companies with a good balance sheet have access to debt financing whereas other companies may have considerable obstacles in getting their banks to commit to the acquisition.

After the last spring's momentary loosening of both operative and financial covenants in loan agreements, our view is that the banks will be requiring tougher covenants as of now. Secondly, we see that some of the Nordic deals continue to be financed through club deals rather than larger syndicates. Thirdly, we see that intercreditor negotiations will become more demanding as the market participants have learned what various protections and restrictions mean - in practice.

Debt Equity Ratio, Multiples and Terms

The Finnish M&A deals that include debt financing completed this autumn and last summer have included around 50% equity and 50% debt. We have seen no mezzanine or second lien tranches. Furthermore, as high yield debt financing has not, in our view, gained the momentum seen in some other countries, there is a clear need for alternative funding sources. The total debt to EBITDA ratio seems to be around 4.5 but we have not seen any evidence which way this ratio might be moving.

A Word on the Loan Margins

Perhaps the most volatile aspect of acquisition finance metrics is the spread or margin of senior loans over EURIBOR. Some of the recent deals have moved around 400-500bps above EURIBOR but it is difficult to determine whether these will rise still. Based on our views of the banking regulation, the margins appear to have risen to a new "usual level". This fact will most likely act in favour of high yield bond financing, which admittedly requires a rating and is usually not available for smaller deals.

Views from the Venture Capital World

The lack of bank participation and debt financing is perhaps most evident in the venture capital side. Most of the growth financing transaction that we have seen are carried out with 100% equity and debt has been present only through the Government sponsored TEKES and Sitra. The same feature has been present in the energy plant investments, where the funding requirements have almost entirely been fulfilled by equity. Some deals are waiting for minority debt investments to secure the required funding. However, the banks' role in such arrangements is understandable as they do not normally take technology risk involved in energy technology projects.

Debt Funds

One recent phenomenon that we have seen and of which there have been discussions are specialist funds that invest in corporate debt - from senior secured to deeply subordinated indebtedness. One reason for this may be the recent peculiarity that some of the bigger corporations have been able to raise debt finance from the markets at a lower rate than some of the banks. This means that their source of funding can compete with that of the banks.

As corporates cannot carry out lending operations without a banking licence, one option is to invest in a fund investing in corporate debt. At its best, such funds may in certain acquisition transactions be able to fulfil the cap caused by lack of bank financing.

The use of debt funds is likely to result in senior debt and mezzanine debt agreements as well as intercreditor agreements that deviate from the agreements used by the banks. This is likely to require a more detailed drafting and structuring process by the lawyers.

Share Exchanges

We see that especially share-based deals are most likely structured as tax neutral arrangements which mean that structural tax planning becomes even more relevant. If the share exchange or use of preference shares is intended to postpone the exit of the investors, the normal transaction documentation should be supplemented with the investment and shareholders' agreements to facilitate the exit.

TRENDS IN MERGERS & ACQUISITIONS

Nordic Deal Activity Relatively High

The M&A activity in the Nordic markets has been at the reasonably high level despite the difficult global recession, but in Q3-Q4 we have already seen the level being lower than the year before. However, we do not expect any major downturn at the beginning of 2012 and in particular the number of international divestments and acquisition deals requiring solid cross-border expertise are likely to increase during 2012.

Another aspect of the current market is an inherent sensitivity in the deals, i.e. the parties may withdraw from the transaction rather easily. However, the deal volumes of certain sectors are higher than some other sectors, which makes it difficult to estimate what will be seen during the remainder of the year and in 2012.

Targets More Mature

As we have indicated earlier, there has been an increase in the number of corporate divestments and other balance sheet arrangements and we do not see this trend diminishing in the near future.

Another rising trend is a tendency to acquire more mature companies than previously. This may result in many potential start-up phase targets not perhaps attracting as much attention.

Cash Deals Reign

As indicated above, the vast majority of the recent deals have been cash financed transactions. One interesting notion is the ratio between locked-box and post-closing adjustment mechanics. At the Nordic level we have seen that purchase price adjustments becoming more stringent than previously. However, the usual adjustment matrices have remained the same, i.e., working capital and net debt.

Geographical Trends

There has been an increased interest in M&A and investments in Nordic region from China and, as this activity has been already quite high in Sweden and Poland, we will likely see a rise in Chinese investments to Finland as well.

However, economic instability has meant that some potential Chinese entrants have already decided to postpone their entry to the Nordic markets.

Joint-Ventures More Popular

In many cases, availability of funds, R&D cycles and risks will force companies to collaborate. Similar examples are seen in the pharmaceutical and mechanical industries. This would most likely mean more IP-intensive joint venture models, collaborations and strategic partnerships.

Use of Earn-outs Increasing?

In light of the above developments in corporate financing, we estimate that preference shares and alternative pricing structures - such as more extensive use of earn-outs - will become more popular as a means of getting acquisition transactions done. However, so far the use of earn-outs have been at the relatively stable level.

Based on the above, the absolute percentage of earn-out amount to the total purchase price would also be slightly increasing and due to the economic uncertainties earn-out periods would be shorter.

Although the level of vendor financing appears not to have increased too much, it is likely to become more relevant to fill the gap between the purchase price and equity-funded portion of the price.

Earn-out is by definition means of ensuring that buyers do not overpay and seller do not undervalue the target. Due to their control-aspect and time-aspect, they are difficult to regulate effectively. This means that legal review of extensive earn-out provisions is of the utmost importance. For those who are interested in the complications involved with earn-outs, please review the recent case of the High Court in: *Porton Capital Technology Funds and others v 3M UK Holdings Limited*

http://www.judiciary.gov.uk/media/judgments/2011/porton-judgment-07112011.

Escrows

The market volatility may also increase the feasibility of escrow arrangements. To yield sufficient protection, it is advisable to contractually enable set-off between earn-out and the Escrow funds (in relation to indemnity claims). As there are evident legal risks relating to such arrangements, it is advisable to structure such an arrangement carefully. It may be advisable to amend the earn-out clauses used in the previous years to reflect the new environment.

Sector-Specific Views: Technology, Telecom and Games Industry

In technology and telecom industry we have seen new entrants such as Ericsson in Oulu and Intel in Tampere and Helsinki. Mobile manufacturers will not compete only with platforms like Windows, iOS or Android, but the focus also shifts to social connectivity and utilisation of cloud (extra-platform connectivity). Furthermore, the Finnish games sector and content business companies are likely to be feasible acquisition targets. One notable example was the recent acquisition of RedLynx by Ubisoft.

There have been several outsourcing cases in telecom-sector in Finland already during the past few years, the drivers usually being employee or intellectual property-related. Structural changes of the industry and increasing use of business process outsourcing (BPO) vendors will also mean that there are more divestments and outsourcing deals coming up in 2012. So far our experience has been that these have been more international than domestic deals.

It should be noted that interest in business process outsourcing cases has been consistent throughout various industries from mechanical to groceries.

Sector-Specific Views: Cleantech

Finland’s other core fields also from M&A perspective in the coming year 2012 are likely to be found in the energy and environmental sectors. Finland has a relatively young green technology industry and many companies struggle to get out of the “valley of death” - from development to first sold product. Some private equity deals have been carried out, but one of the techniques for getting get back on the track might be use of public-private co-operation arrangements or joint venture models based on risk-sharing strategies.

Due to the financing difficulties, we expect to see tendency for venture capital to focus on enabling technologies - energy efficiency being the core growth area. This provides not only more mature technologies but also shorter investment cycles.

Sector-specific Views: Information Technology and IT Services

Increased level of investments in IT is also evidenced by the latest research by Tietotekniikanliitto (Finnish Information Technology Association) which estimates that during the next year 2012 investments in IT sector will reach the pre-credit crunch levels. IT outsourcing deals continue to be small and less driven by transactional models. Transactional models (asset deals) may still be relevant in public sector depending on the outcome of municipality and state-level IT centralisation plans.

Multi-sourcing environments will be a hot topic, if not already, during 2012. System integrators will be playing a crucial and increasing role in the markets and we expect increasing M&A activity and market consolidation in this sector. At the international level IT and IT services-sectors have been very active from transaction perspective in year 2011 and during 2012 we expect to see even more perhaps smaller strategic acquisitions of small and medium-size IT companies.

DEALING WITH CORPORATE RESTRUCTURING

A large part of debt and corporate restructuring activity in Finland has revolver around debt rescheduling, i.e. extending the maturity of the bank loans, covenant modifications coupled with rises in the interest margin and charging of amendment fees by the banks. The general level of amendment fees has been around 45-60bps and the level of additional interest margin has been around 100-150bps.

As an interesting point, at the Annual European meeting of the Turnaround Management Association in June 2011, the general view of the market participants was that an increase in the general interest rates of 1% point would lead to a wave of restructurings. Even though the general rates have not gone up, the rise of the loan margins and the additional interest margins increase the interest payments in a similar way. Therefore, these factors may have an effect on the near to medium term restructuring transaction volume.

We have seen only a few large-scale restructurings and most of these have been a part of a larger usually London-led overall corporate restructuring process. Also capital injections by private equity houses and the owners have been common during the last years.

On a general level, the number of corporate restructurings and distress M&A is likely to rise in the near term. Furthermore, some of the amended financing arrangements will have to be restructured within ca. two years' time. There are several reasons for this, but from our point of view, the most important are:

1. the Finnish economy will most likely have a negative growth at least for the end of 2011 and some of the corporates are struggling to secure their refinancing and growth investments;

2. companies have carried out most of their structural changes and liquidity enhancing operations so in a no-growth environment, the next restructuring measures will have to relate to debt write-offs or divestments; and

3. it is expected that the capital requirements of the banks and certain other regulatory factors will result in pressure to increase loan margins on a general level (not the underlying interest rate though).

The upside with the restructuring environment is that the parties are better equipped to understand the mechanics of intercreditor agreements and the buyer appetite for distressed deals has gone up. We have seen that enforcement of share security as a means of affecting a restructuring has been a workable solution for the lenders especially in voluntary restructurings based on intercreditor agreements.

There have been certain prominent Distressed M&A transactions carried out through the corporate insolvency procedures (most notable the recent Moventas-transaction). However, these have proven to be economically the least favourable restructuring scenarios as the distressed entity may have lost its most profitable contracts, best employees and most of the goodwill.

One notable aspect that we have seen is toughening of the junior creditors' views in relation to senior lenders and the owners. As a matter of debt priority rules, the junior creditors are often - and in all respects - subordinated to the senior creditors but relatively unprotected if the senior creditors negotiate a recapitalization transaction with the equity sponsors.

If the equity sponsors are able to persuade the senior creditors of the feasibility of the new capital structure, the junior creditors often have little to say. Needless to say, this creates tension between the creditors and requires professional and diligent negotiation strategy and tactics.

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